Q2 2023 MARKET REVIEW

Fund Literature	Fund Facts	Latest Fund Webinar

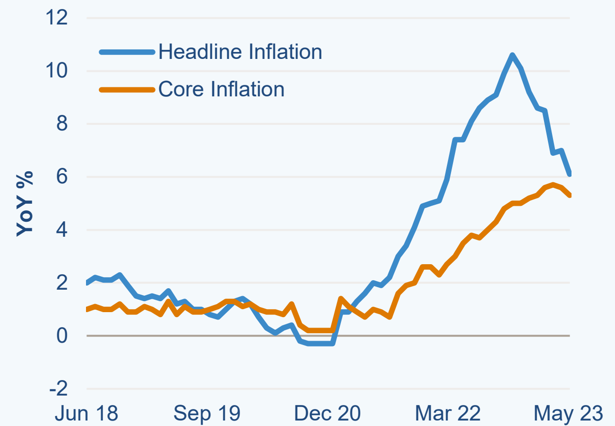
Falling Inflation, Rising Rates

Market Review

Earnings Growth Sets the Scene for a Positive Outlook

European markets rose modestly in the second quarter by 1% in euro terms amidst a backdrop of declining market volatility. May was the first down month of 2023, but equities bounced back in June. The second quarter was dominated by the sustained strength in inflation and further interest rate hikes in Europe and other developed areas. Eurozone headline inflation fell from 7% in April to 5.5% in June, whilst core inflation made a much more modest decline from 5.6% to 5.4%.

Inflation is transitioning from being driven by energy and food to being driven by wages, particularly in the services sector. The ECB raised rates at the May and June meetings, leaving the deposit rate at 3.5%. Reinvestments under the asset purchase program are expected to end from July. New ECB staff forecasts produced at the June meeting foresee headline and core inflation both at 3% in 2024 and both remaining above 2% in 2025.



Source: Bloomberg as at 31 May 2023.

GDP in the Eurozone was revised down to -0.1% in Q1, with a particularly weak performance in Germany which saw a fall of 0.3% quarter-on-quarter after a 0.5% decline in Q4. Full-year forecasts for the Eurozone have seen some small downward revisions to 0.6%. The composite PMI declined from 53.7 at the end of the first quarter to 49.9 at the end of June. Globally, the manufacturing sector is showing weakness, with the PMI staying in contractionary territory at 48.8. Unemployment made a new low of 6.6%, whilst consumer confidence continued to make incremental improvements through the quarter.

The first quarter earnings season was well received and earnings forecasts for the full year inflected higher; some modest downward revisions were seen in June. Banks produced particularly strong Q1 results, benefitting from deposit pricing pass-through staying low whilst rates are rising. Towards the end of the quarter, some weaker outlooks were given by companies in the chemical sector in particular. There was frenzied excitement in regards to artificial intelligence following NVIDIA's strong guidance later in May, helping to drive outperformance by the tech sector in the US and also in Europe for the rest of the quarter.

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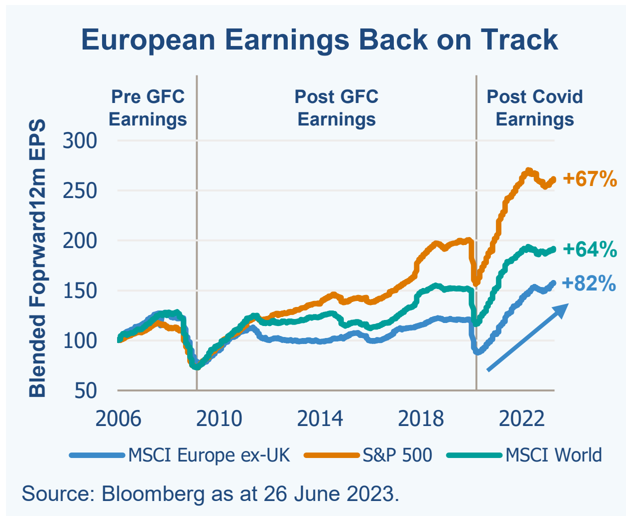

Source: Bloomberg as at 26 June 2023.

After the issues within the US regional banking sector in March, there remained a focus on credit markets and credit availability. Bond markets saw large moves over the quarter with much higher short-dated yields, higher yields across the curve and even more inversion. German 10-year yields rose 10bps over the quarter to 2.39%, whilst 2-year yields rose 52bps to close at 3.19%. Early in April we saw a surprise cut in OPEC+ oil production by 1.16 million barrels per day, with Saudi Arabia accounting for 0.5m of the cut. This follows the supply reduction that was announced in October of last year. Wholesale gas prices fell 21% over the quarter and are down 50% year-to-date, despite an upward move in June.

Q2 saw a fairly wide differential in sector performance. The strongest sector – for the second quarter in a row – was technology, which outperformed by 3%. Thereafter healthcare, industrials, consumer discretionary and utilities each outperformed by 1%. Communication services was the weakest sector, underperforming by nearly 8%, followed by energy at 4.5%. Consumer staples, materials and real estate all underperformed by 2 to 3%.

Performance and Key Decisions

Cautious, But Buying the Dips

In aggregate, industrials performance was strong, with Spie and Schneider contributing the most. This was followed by financials, where we were, on average, slightly underweight for the quarter, driven by strong performances from Unicredit and ASR. Materials were also a notable positive.

Unicredit was a strong contributor over the period after announcing a huge beat at the Q1 results, guiding consensus higher for full-year net interest income and affirming its total shareholder distribution policy giving a near 15% yield for 2023. Comments through the quarter highlighted the benign outlook for provisioning and deposit pricing, whilst the capital position at 16.1% will allow strong shareholder returns for the years to come. ASR also performed well after a period of weaker performance, not least as we are getting closer to the closure of its takeover of Aegon in the Netherlands, which is highly accretive.

Deutsche Telekom underperformed after concerns arose that Amazon may launch a mobile service in the US, which hit all the US carriers. Deutsche Telekom's equity story is much predicated on the success of T Mobile USA, of which it owns 50%. Debate continues over whether Amazon will make an entry, possibly with the satellite company Dish, which currently has around 70% US mobile coverage. Dish buys capacity from T Mobile and AT&T, but contracts prevent reselling to Amazon. Heineken was weak after a €3bn placing of Heineken by FEMSA, the Latin American bottler. This removed a share overhang and we added to our position. The stock has a few short-term headwinds with Nigerian devaluation and weakness in Vietnam, but on 15x next year with a raw materials tailwind, we believe it is undervalued. The main new position buys over the quarter were Ryanair, ING and Julius Baer. Ryanair goes from strength to strength as regards its ever-growing market share, supported by being at 125% of pre-covid capacity, whilst maintaining best-in-class operating costs with a widening gap to peers. We are of the opinion that valuation looks too cheap on a 2024 onwards basis at a time when free cash flow is inflecting with peak

capex in 2023, despite the fact capacity growth of around 10% is possible in the coming years driven by the new Boeing deliveries. The new Boeing 737 MAX-10 deal facilitates growth from 2027 to beyond 2030, whilst significantly improving fuel efficiency.

Current Positioning

Remaining Defensive

Overall, during the quarter, we remained in the fairly defensive positioning that evolved towards the second half of the first quarter. The largest overweights are utilities, communications and staples. The industrials weight rose the most over the period (2.8%), with continued strong demand for those names exposed to the Green Deal type drivers such as Schneider and St Gobain. Within staples (2.5%), we added to Heineken, now the fund's largest active weight. Within utilities (1.3%), we increased our exposure to the renewable generators given the policy demand for their output only increases. Whilst we are aware that rising yields can be a headwind to the performance of some of these sectors, we believe we are closer to the peak of rising yields.

The main underweights at the end of the quarter are consumer discretionary, banks, energy and materials. The reduction in financials was the largest move, in effect confirming our view that the banks sector, whilst benefitting from current tailwinds, is near the peak as regards the dual driver of net interest income and favorable credit cycle conditions. Healthcare was also reduced, mainly through Roche, where we decided to reduce the large position size after some outperformance whilst remaining overweight the stock.

Outlook

A Strong First Half, with Valuations Still Attractive

Markets have been strong in H1 2023, much stronger than many, including ourselves, expected, buoyed by positioning and developments in the technology sector. We think it will be hard for things to continue so relatively seamlessly in the second half of the year, given the headwinds from the lagged impact of monetary policy are set to increase further. Interest rates are set to move higher in Europe in July and possibly also in September, which will leave the area with rates below some of its developed market peers, but still high in an absolute sense. It has become very clear that the inflation genie has not yet been tamed. Wage growth this year is likely to exceed 4% but set against a still tight labour market, it remains possible that wage increases for next year stay high.

Altogether, we see a likelihood that rates stay higher for longer, with the first cut not until the middle to end of next year, leaving us with growth headwinds and being too far away from the optimism of a monetary policy inflection. The outlook for consumption remains a key focus area for the second half, and we are seeing incremental improvements in consumer confidence despite the headwinds from rates, house prices and still high food prices. Positive real wage growth becomes a possibility later in the year, which would be a kicker to further confidence improvements, not least if the unemployment level stays close to the current cyclical lows.

As ever equity, markets will always be quick in anticipating the start of a new cycle, but we think it would be premature to move yet and are therefore holding a higher-than-average weighting in non-cyclicals. We are pleased with the core of the portfolio exposed to many structural themes, not least within electrification, decarbonisation, healthcare and digitalisation.

A key positive for Europe remains valuations are at average cycle levels, at a little over 13x next year; thus, on a relative basis, the region looks much more attractive than many. We believe beyond shorter term headwinds, Europe may be at the start of a medium-term re-rating story, given the index composition is leading to a faster growth, higher quality and less cyclical outlook.

J O Hambro Capital Management Group

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Paul Wild
Senior Fund Manager

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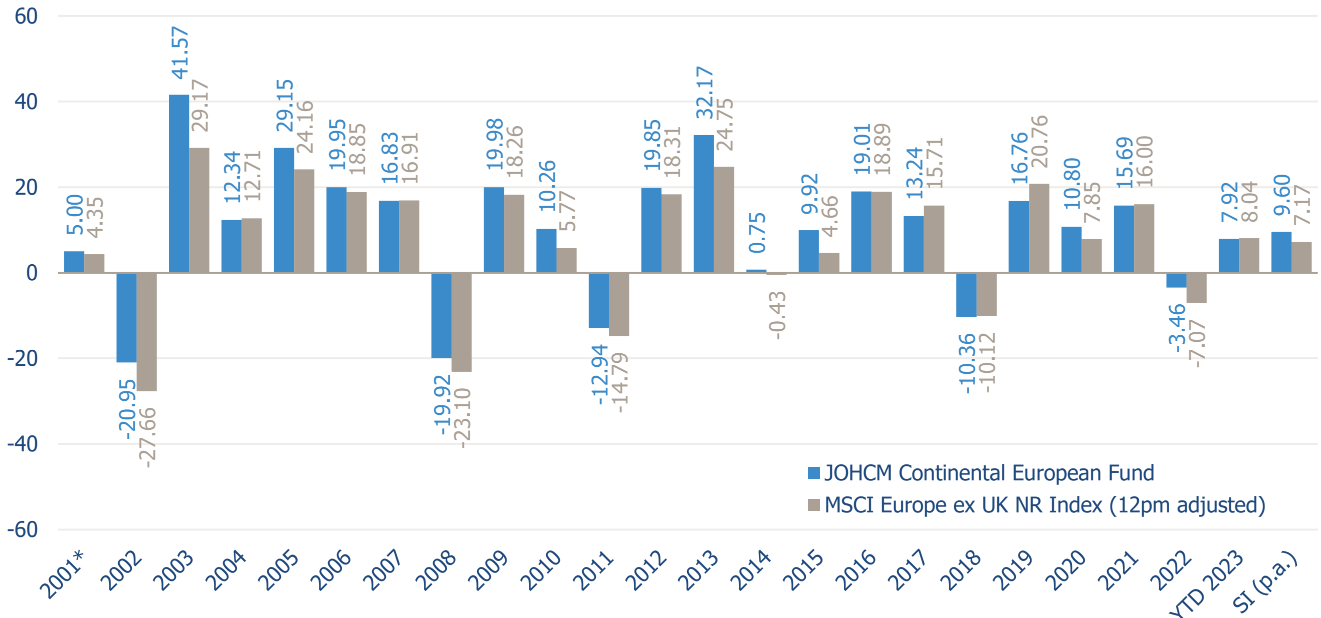
FUND PERFORMANCE

JOHCM Continental European Fund (GBP) (%): 4 November 2001 – 30 June 2023



Periodic performance (%)	1 month	3 month	1 year	3 years	5 years	SI	SI annualised
Fund	**0.38**	**-0.29**	**21.22**	**34.73**	**40.14**	**628.09**	**9.60**
Benchmark	0.90	0.32	20.03	28.82	38.53	348.25	7.17
Relative return[1]	-0.51	-0.61	0.99	4.59	1.16	62.43	2.26

Discrete performance (%)	30 Jun 23	30 Jun 22	30 Jun 21	30 Jun 20	30 Jun 19
Fund	**21.22**	**-8.31**	**21.22**	**2.23**	**1.75**
Benchmark	20.03	-11.44	21.19	0.57	6.93
Relative return[1]	0.99	3.54	0.02	1.65	-4.84

Past performance is not necessarily a guide to future performance. The value of an investment can go down as well as up and investors may not get back the amount invested. For further information on risks please refer to the Fund's KIID and/or the Prospectus. Source: JOHCM/MSCI Barra. NAV of share class A in GBP, net income reinvested, net of fees, as at 30 June 2023. Benchmark: During the period 4 November 2001 to 31 December 2012 the Fund was benchmarked against the FTSE Eurofirst 300 TR Index. For the period 1 January 2013 to present the Fund is benchmarked against the MSCI Europe ex UK NR Index (12pm adjusted). Performance of other share classes may vary and is available upon request. *Part period return since inception 7 May 2003 to 31 December 2003.

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